Student
Financial
Assistance

Financial Partners Channel

Default Reduction Management Report

Statement of Purpose

This report is intended to provide a summary of best practices, improvement opportunities and recommendations for default management and debt collections for SFA.

- The default reduction effort involved assessing SFA's past, current and projected default data, along with industry best practices to identify recommendations for managing delinquencies and defaults.
- These recommendations identify opportunities for SFA to work with Lenders, Guaranty Agencies (GAs), Servicers and other key stakeholders to prevent and/or reduce defaults.
- While the scope focuses on managing defaults for the FFEL Program, the findings also should be useful in defining opportunities to prevent or reduce default in the Direct Lending and Federal Perkins Loan Programs.

Overview

Student Financial Assistance

During this project, the team identified the current situation, analyzed the financial industry and its best practices, and developed recommendations to support default management and reduction.

- Financial industry risk management, borrower behavior and default rates, particularly in the area of unsecured personal loans.
- Current technologies used in the financial services industry to analyze delinquent and defaulted borrower characteristics.
- Debt Collection Services (DCS), including default prevention and reduction pilot programs.
- Default prevention programs currently implemented by the Financial Partners, including Great Lakes, USA Group, Sallie Mae, and Nellie Mae.
- Calculation, tracking and analysis of delinquency and default rates.
- Related Federal and State Agency default reduction efforts.
- Current and proposed regulations regarding default prevention and reduction.

Overview - continued

Major tasks during the project included:

- Research in authoritative sources:
  - Forrester Research, Jupiter Communications
  - Gartner Group
  - Internet (www.ed.gov and other education related sites)

- Leverage industry professional associations, including NCHELP and Consumer Banking Association (CBA)

- Interview / brainstorm with SFA key contacts:
  - Gary Hopkins - Default reduction and debt collection activities
  - Shirley Wheeler - Public Awareness Campaign
  - Lynda Gaddy – Contracted Private Collection Agencies (PCA) process
  - Adele Garbrielli – Federal Tax Offset Program (TOP)
  - David Hammond - Default reduction and debt collection activities
  - Joe Weber - ad-hoc reports

- Interview / brainstorm with Default Management Division:
  - Patricia Trubia - current default prevention programs
  - Tara Porter - recent presentations on default management

- Attend Industry Conferences:
  - NASFAA Conference - collected information from Texas Guaranty Agency,Great Lakes Higher Education Authority, Pennsylvania Higher Education Assistance Agency (PHEAA), USA Group, American Education Services, Sallie Mae, Nellie Mae, Chela Financials, Student Finance Corporation
  - Attend Treasury's New PCA Contract workshop

- Discuss with Technology Vendors and Service Providers, including Federal Asset Advisory Company, CACI, HNC, and Equifax

Current Environment

Recent SFA Debt Collection Services programs have assisted in reducing the overall default rate to 8.8%, including Public Awareness campaigns, Tax Offset Programs, and a wage garnishment program.

- G.A.s and Lenders average about 15.5% for early stage default collections.
- ED's wage garnishment program increased to $ 44 million for FY1998 since 1995.
- Collections from the Treasury-Offset Program (TOP) were approximately $550,000 per year from 1994 to 1996, and have risen steadily to over $1.4 Billion for FY2000. According to a recent OIG Report, TOPs is the single most successful method to collecting on defaulted government loans.
- Private Collection Agencies (PCAs) currently contracted with ED serviced about 27% of the accounts transferred and collected on approximately 1.78% of the total transfer balance for late stage default collections (or 1.37% net of collection costs).

However, current defaulted student loans total about $28 billion for the FFELP and William D. Ford Federal Direct Loan Programs.

Current Environment - continued

Student Financial Assistance

Federal Student Financial Aid currently provides almost $40 Billion per year, with expected increases in the future.

- The FFEL Program Stafford Loans currently provide more that $20 Billion in student aid each year, which is the largest single component of federal financial aid. Direct Lending provides an additional $10 billion per year, with Federal Grant programs (Pell and FSEOG) providing about $8.5 Billion per year.

- Almost 30 million students enrolled in post-secondary education programs in 1999, with an average of 50% of all students receiving some type of financial aid (including scholarships, grants, and loans) and 37% receiving Federal aid. This number is expected to increase by 11-13% by the 2007-2008 school year, with the largest increase expected in the 18-24 year old sector.

- From 1989 to 1999, educational costs, including tuition, room and board, increased approximately 22% at public four-year colleges and 28% at private institutions, as compared with a 12% increase in expenditures per student at the institutions for the period (after adjusting for inflation). Further, Institutional costs are projected to increase an additional 40% by the 2007-2008 school year.

Current Environment - continued

Almost 50% of students receive financial aid for postsecondary education and over half of that aid is in form of student loans. The increasing cost of education is causing post-graduation indebtedness to reach significant proportions.

- A recent federal study on 1993 graduates has found that, four years after receiving their college diplomas, only 16 percent of student borrowers were debt-free. About half of those surveyed – 51 percent – incurred debt averaging $10,000. The debt averaged $66,200 for those who completed a professional degree by 1997.

- The American Association of Medical Colleges (AAMC) tracks indebtedness of medical students. The association's most recent data show that the average indebtedness for medical school students who graduated in 1997 was $80,462, an increase of 7.1% from the average debt load of $75,103 reported by the class of 1996. The median loan balance rose nearly 12% to $80,000 from $71,500.

- According to the College Board's 1997 Trends in Student Aid report, non-federal borrowing by postsecondary students jumped 15% to $1.5 billion during the 1996-97 financial aid award year. This number only includes large private loan programs provided by lenders, state agencies and others.

- A 1997 survey of college borrowers by Nellie Mae showed that 26% of the respondents have used credit cards to help finance their education.

Current Environment - continued

Numerous studies have shown that the probability of default increases with an increase of total debt burden. From 1995 to 1999 the total debt burden for graduating students has risen dramatically, with total borrower indebtedness increasing:

- 19% for four-year undergraduate programs, to $10,173 in 1999.
- 100% for graduate programs, to $24,479 in 1999.
- Over 30% for two-year community college programs, up to $3,565 in 1999.
- Nearly 70 % for proprietary schools, increasing to $8,551 in 1999.

A recent study conducted by USA Group shows that a growing percentage of borrowers are seeking ways to reduce their monthly payment burden.

- 8.5% of Stafford borrowers and 18% of consolidation borrowers entering repayment are now choosing graduated repayment, up almost 19% from a year earlier.
- Record numbers of post-grace period Stafford borrowers are using deferment and forbearance to postpone their loan payment, with nearly 1 in 5 borrowers with unsubsidized Stafford loans in forbearance.
- The study results indicated that after graduation, borrowers do not have the financial capability to repay their scheduled loans. Deferment and forbearance are signs of financial stress, as evidenced by unemployment or underemployment.

Current Environment - continued

Alternative repayment and loan forgiveness programs are becoming more prevalent and impact the total cost of student loans to SFA.

A recent study conducted by the National Council of Higher Education Loan Programs and Education Finance Council indicated that borrowers are forgiven a portion of the loan amount after up to 25 years of on-time repayment under the Income Contingent Repayment (ICR) plan. (Source: "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment under the Forgiveness Program")

Amount borrowed	$10,000	$25,000	$50,000	$100,000
Amount paid by borrowers over 25 years	$24,032	$57,373	$84,261	$ 86,751
Unpaid balance forgiven by ED at end of 25 years	$ 2,094	$21,631	$78,573	$239,035

[Assumptions: Single borrower, initial income of $15,000, rising 5% annually, based on an interest rate of 8.25% and 3% annual inflation]

Current Environment - continued

The Pell Grant maximum award for 1999 was $3,125. However, the actual grant award averaged $1,923 per student, as compared with the average tuition for four-year institutions, which averaged $6,672. This funding gap can be prohibitive for lower-income students.

- Only 47 percent of low-income high school graduates immediately enroll in a college or trade school, as compared to 82 percent of high-income students. (National Center for Education Statistics, Condition of Education 1999)

- Only 18 percent of African-Americans and 19 percent of Hispanic high school graduates earn a bachelor’s degree by their late twenties, compared to 35 percent of caucasians. (NCES, Condition of Education 1999)

- 22 percent of college-qualified high school graduates with low family incomes do not pursue post-secondary education, as compared to only 4 percent of high-income graduates. (NCES, Access to Postsecondary Education for 1992 High School Graduates)

For FY2000, a reported $132 million Pell Grant surplus, which has accumulated from prior years, provides opportunity to evaluate use of grants in relation to student lending.

Current Environment - continued

Proprietary schools reflect both the highest default rate and highest incidence of reported fraud; however, they currently represent only a small percentage of the Title IV loans.

- Proprietary school owners are the largest single group who have been indicted or sanctioned for student lending fraud (over the past 3 years), totaling over $160 million the 18 month period from September 1998 to March 2000.
- Proprietary schools currently have an average default rate of 15.5% (over 75% above the overall default rate of 8.8%), with almost 30% of defaulted borrowers from these schools.
- According to a May 1999 study, proprietary school loans constitute more than 50% of the DCS defaulted loan portfolio, both in amount and number of borrowers.
- The default rate in some vocational and trade schools has reached 68%, and averaged to 33%, several times more than the rate at four-year schools. (Source: www.nolo.encyclopedia.com)

Default prevention and default reduction activities occur at different stages during the life of a loan, with a focus on prevention at or before loan origination.

Default Prevention

Default Reduction

Entities	Loan Origination	Fund Disbursement	In School/ In Grace	Repayment	Delinquent	Default	Claims and Claims Payout	DCS Collection
Borrowers	X	X	X	X	X	X	X	X
Schools	X	X	X					
Guaranty Agencies	X	X		X	X	X	X	
Lenders	X	X		X	X	X	X	
Servicers		X		X	X	X	X	
Secondary Markets				X	X	X		
SFA		X		X		X		X
Collection Agencies						X		X

Days past due 1 270* 390**

* Default status was increased from 180 to 270 days past due in 1998

** Lenders are entitled to 60 days to file a claim and guaranty agencies are entitled to 60 days to pay a claim

Industry Analysis & Best Practices - continued

Predictive software is becoming increasingly sophisticated and useful in analyzing and predicting borrower behavior and the recoverability of delinquent and defaulted loans. Examples of innovation in debt collection include debt portfolio valuation, delinquent prevention and debt collection systems, and portfolio management technology.

Debt Portfolio Valuation Service

The HNC Debt Portfolio Valuation Service uses a predictive software to analyze debt portfolios to predict the recoverability of the individual accounts and forecast whether the purchase price of the portfolio allows a positive net present value for the debt acquirer. Based on proprietary neural network modeling technology, HNC's predictions of the recovery profile of a debt portfolio are more accurate than other methods.

The model can analyze a debt portfolio, understand its composition, estimate the relative level of wealth associated with the debtors, and provide a statistical evaluation of future liquidation. Once the custom model is built, HNC will score debt portfolios that the client is considering for purchase and, for those it buys, provide quarterly updates on how the portfolio of accounts is liquidating.

Delinquent Prevention and Debt Collection Systems

- USA Group successfully implemented an in-house delinquency prevention and debt collection system. This Borrower Pursuit System (BPS) currently is used by USA Group, Oklahoma Guaranty Agency, Sallie Mae, and NELA. The system is designed to assist in G.A. debt collection and can be customized easily to manage lender collection activities. The system has several integrated solutions in delinquent prevention and debt collection:
  - Automatically detect the optimal time to call the borrower based on the borrower's home location, employment nature and borrower's preference.
  - Mosaic Auto Dialer to route the call to the collection representative if the borrower is at home.
  - User-friendly control parameters can be set by the user to determine different types of delinquent prevention campaigns based on the principle amount and the stage of the delinquency.
- CACI has a strong history of supporting technology-based debt recovery and management services for federal agencies and commercial enterprises. For instance, with Department of Justice (DOJ), a client CACI has supported for nearly 20 years, CACI has developed an automated debt management system called the Collection Litigation Automated Support System (CLASS). The DOJ, the "collector of the last resort" for the federal government, collects a wide variety of debts owed to the United States, from delinquent student loans in the tens of thousands of dollars, to Superfund-related environmental pollution recoveries in the millions of dollars.

  CLASS tracks and calculates the amount and distribution of debts referred by other agencies and tracks the litigation process by generating legal documents maintaining information for courts and attorneys. The system is installed nationwide, with all 94 U.S. Attorneys offices, private counsels, and Washington D.C. area DOJ offices.

Portfolio Management Technology (STRATA)

USAF utilizes portfolio management software called STRATA to control the placement and recall of its accounts from private collection agencies. STRATA allows USAF to experiment with different placement strategies simultaneously. They use the software to place or recall most accounts according to the optimal model, but at the same time, place some test groups according to a different model. STRATA allows them to vary their selection criteria by selecting different parameters for multiple data elements.

Through this process of monitoring and testing their portfolio management strategy—they call the tool "champion challenger"—USAF can continuously improve their results. USAF makes placements according to competitive rankings of agency performance. Their agencies are divided into two sub-groups: first placement agencies and second placement agencies. Within these two groups, the agencies are ranked by their netback recovery rate. Second placement agencies are provided further incentive to perform well because USAF occasionally promotes them to first placement status, based on performance.

Portfolio Management Technology (London Bridge)

London Bridge has developed a product line to support the needs of front-end collections operating in a traditional mainframe, client-server or thin-client environment. With the changing environment of receivables management, the need to retain and enhance customer relationships adds a new dimension to the timely collection of outstanding debt. Collectors must have immediate access to the tools that allow them to contact customers directly, record promises to pay, make notations, and track recurring commitments.

London Bridge products manage the unique activities associated with the collection process, in the context of their clients' individual company or industry segments, including:

- Legal - Tracks consumer legal cases through the courts automatically.
- Credit Risk Assessment - Uses intelligence models to determine the treatment path for likelihood and amount of collection.
- Data Mining and Monitoring - Uses historical information to improve collectibles and provide reports to monitor activities and levels of success.

London Bridge's products also assist the debt recovery industry in collecting assets that have been charged-off or listed as uncollectable. The wide range of integrated, fully automated recovery and agency management systems maximize recoveries and minimize costs by providing complete control over the entire recovery process. The products consider all relevant information needed for the unique needs of successful recovery operations.

Opportunities for SFA

Federal Student Financial Assistance is not currently tied to academic performance, only enrollment.

Many grant and scholarship programs require the student to apply for student loans as a prerequisite to obtaining funding (as a secondary source for education costs that are not covered by loans)

The William D. Ford Direct Loan portfolio can be expected to increase its default rate, as the portfolio ages and more borrowers enter repayment.

Proposed legislation could increase SFA's volume of debt collection by including defaulted Federal Perkins Loans. As a result, reported default rates could increase, in the short term, by including Perkins Loans in the overall default calculations.

Opportunities for SFA - continued

Financial aid is the key to a college education and understanding the entire college financial aid process is vital. Scholarships, grants and all other forms of college financial aid, typically go to those who know the most about the financial aid system or seek to understand the system best.

- Gift aid in the form of scholarships and grants is available from federal, state and local governments and from a wide variety of private sources including businesses, foundations, community groups, colleges and universities:
  - Need-based federal grants: Pell and Federal Supplemental Education Opportunity Grant (FSEOG)
  - Merit-based federal scholarship: National Merit Scholarship. Students must score competitively on Preliminary Scholastic Aptitude Test (PSAT).
  - State scholarships and grants: All 50 states offer some form of scholarships and grants.
  - Private scholarships and grants: Information is available through libraries, financial aid offices and the internet.

However, a recent study has indicated that as much as $10 Billion of grant and scholarship money goes undistributed each year because no one applies.

Opportunities for SFA - continued

Student Financial Assistance

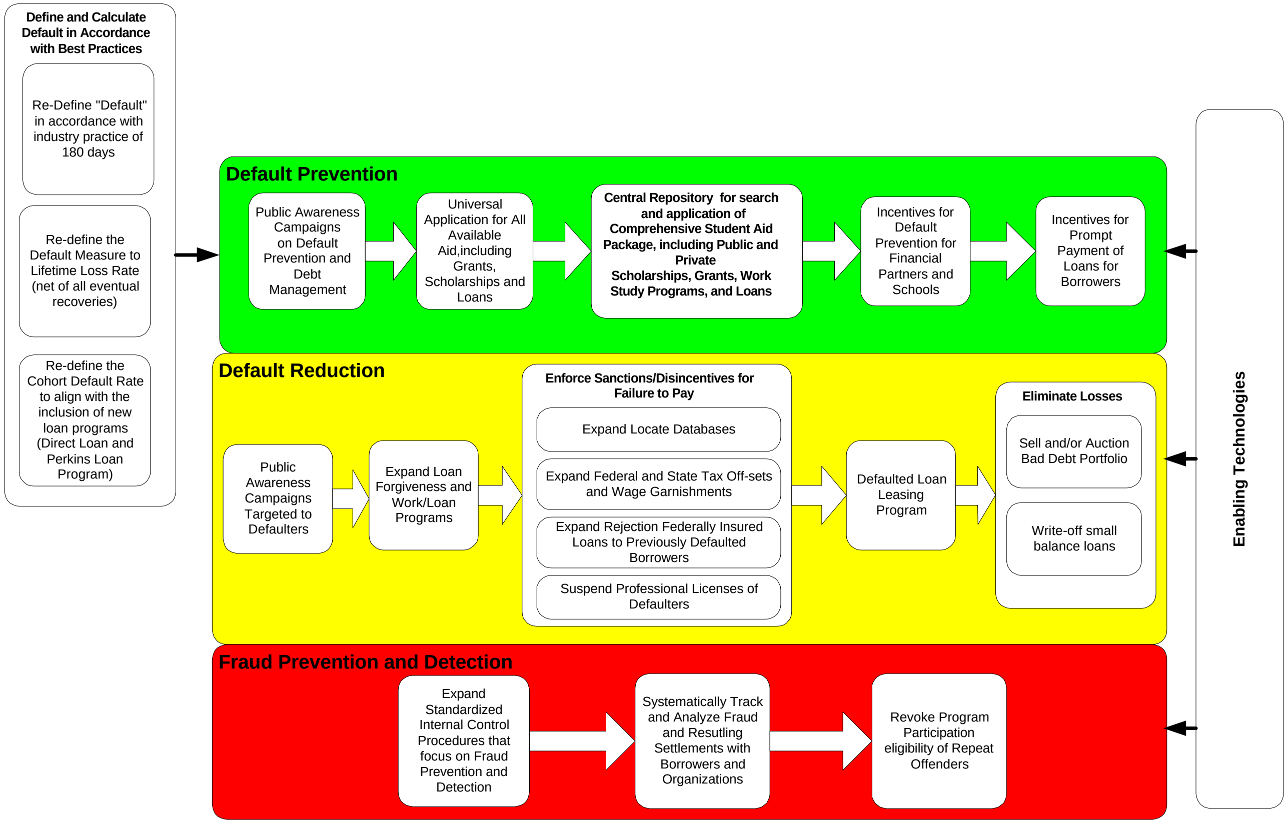
The current Debt Collection Management System (DCMS) is a 30 year old legacy IBM Mainframe system written in COBOL. This system is costly to maintain and lacks the flexibility, scalability and compatibility to interface easily with internal and external systems.

- The FFELP loan status information received by the Department from guaranty agencies in many instances is inaccurate, and remains so when incorporated into the NSLDS.

- Inaccurate loan data limits the Department's ability to use its database to determine the reasonableness of FFELP lender billings for interest and special allowance and may result in overpayment of loan reinsurance to guaranty agencies.

- System maintenance for the DCMS (as part of FFEL system) costs about $8 -10 million per year.

A Comprehensive Default Management program needs to be coordinated across all phases of the loan life cycle, with a focus on prevention to minimize financial exposure to SFA and taxpayers.



Recommendations - continued

Define and Calculate Default in Accordance with Best Practices

Re-Define "Default" in accordance with industry practice of 180 days

Re-define the Default Measure to Lifetime Loss Rate (net of all eventual recoveries)

Re-define the Cohort Default Rate to align with the inclusion of new loan programs (Direct Loan and Perkins Loan Program)

Recommendation

Define and calculate Default in Accordance with Best Practices

- Re-define the time frame for default to 180 days, in accordance with industry standards and best practices.
- Re-define the default measure to Lifetime Loss rate/amount, net of all eventual collections.
- Re-define the Cohort Default Rate to align with recent changes in the programs.

Benefits:

Improves the chance of collecting on defaulted loans, with earlier intervention.

Costs:

Reported default rates will increase in the short term as a result of recalculations.

Modify databases and systems for default rate calculations.

Recommendations – continued

Prevention is the most effective default reduction measure because it saves 100% of revenue that would be lost as the result of default. By reducing the number of defaulted borrowers by 1%, SFA could save $2.3 billion.

Objectives:

Implement an Enhanced Default Prevention Program to reduce the number of borrowers that default and reduce the average loan balance of those borrowers that ultimately default.

Increase percent distribution of available student aid funds by increasing awareness and access to Scholarship, Grant and Loan information, and make loan the last priority for student aid.

Desired Outcomes:

- Reduced total indebtedness at time of graduation by 20%, with an emphasis on the most financially needy students and reduced number of defaulted borrowers
- Reduce total indebtedness of borrowers who drop out by linking loan amount to academic performance.

Recommendations - continued

Student
Financial
Assistance

Public Awareness Campaigns on Default Prevention and Debt Management

Recommendation

Expand Public Awareness Campaign on Default Prevention and Debt Management

- Change public perception of DCS from collection services to Credit Excellence Center by conducting Credit Excellence Campaign.
- The Campaign must focus on providing students incentives if paying on time and on schedule instead of punishment based programs:
  - Expand the existing public awareness campaigns by leveraging existing communication channels and targeting specific student groups.
  - Conduct public awareness campaigns with a focus on personal financial management, using multi-language expertise to meet the needs of the diversified student and parent community.
- Conduct parent/borrower workshops on financial aid and lending programs at high school and first year of college.

Benefits:

Increase Aid Awareness and Streamline Application Process for Students.

Reduces default rates and collection costs by preventing default.

Costs:

Cost of implementing the campaign could range from $5 to $500 per student, depending on the type of program (e.g., internet-based tutorials, videos, on-site conferences).

Recommendations - continued

Student Financial Assistance

Universal Application for All Available Aid,including Grants, Scholarships and Loans

Recommendation

Universal application for all available Aid, including Grants, Scholarships and Loans.

- Increase awareness of other existing financial aid available to students, and not limited to student loans.
- Increase access to Grants, Scholarships (Private & Public).
- Develop and implement universal Student Aid application guide for available Grants, Scholarships and loans, with loans used as the lowest priority to reduce total indebtedness resulting from post-secondary education.
- Develop and implement electronic student aid application, which will explore the possibilities of all the aid programs available upon input, and automatic processing of the application with immediate results of the best aid program for the particular borrower.
- Provide student loans as the last resort, after exhausting all other options.

Benefits:

Improves borrower satisfaction and ability to repay loans by lowering overall indebtedness.

Reduces default rates and collection costs.

Costs:

Reduces current surplus levels of Grant Programs.

Cost of consolidating application forms for loans and grants.

Cost of Development of Central Repository (in conjunction with the CIO Data Warehousing Project).

Recommendations - continued

Central Repository for search and application of Comprehensive Student Aid Package, including Public and Private Scholarships, Grants, Work Study Programs, and Loans

Recommendation

Develop a Central Repository of search and application of comprehensive student Aid package, including Public and Private Scholarships, Grants, Work/study programs and loans.

- Implement a proactive approach to publishing all available public and private grants, scholarships and financial aid information to the students and parents, thus creating an equal opportunity for all students regardless of their resources and backgrounds.
- Establish a public-private alliance by creating a centralized Internet portal containing information and links to all public Grants, and financial aid, private scholarships, private grants as well as corporation scholarships.
- Develop a central repository to provide information and eligibility determination for Public and Private Scholarship, Grants and loans.
- Create an effective communication strategy to deliver the information to students via the Internet and other communication tools.
- Include all the information in the application for financial aid package.

Benefits:

Increase Aid Awareness and Streamline Application Process for Students

Reduce student indebtedness upon graduation

Reduces default rates and collection costs

Costs:

Cost of consolidating application forms for loans and grants

Development of Central Repository

Recommendations – continued

Student Financial Assistance

Incentives for Default Prevention for Financial Partners and Schools

Recommendation

Incentives for Default prevention for financial partners and schools.

- Require lenders and schools to implement the Default Management Plan.
- Reward the financial partners and schools who successfully implement the default prevention programs by providing financial or operational incentives, such as incentives similar to the default aversion program, fewer oversight requirements, etc.
- Verify default prevention program execution during the oversight review process.
- Establish guidelines for Guaranty Agencies to intervene at early delinquency stages, when the loans are still with the lenders, with established incentives for performance.

Benefits:

Prevent delinquent borrowers from defaulting.

A 1% reduction in default rate as a result of prevention efforts could result in a $2.3 billion savings to ED.

Costs:

Changes in regulations to simplify regulations and provide incentives for performance.

Additional coordination with and oversight of FPs and schools.

Recommendations - continued

Student
Financial
Assistance

Incentives for Prompt Payment of Loans for Borrowers

Recommendation

Incentives for prompt payment of loans for borrowers.

Provide incentives to students to enter the ‘smart’ repayment program.

- Provide borrowers who make auto-debit or electronic repayments to a ¼ percent point interest rate reduction as long as they repay through the loan.
- Provide borrowers who make their initial 48 schedule payments on time to a 2 percent interest reduction.
- Provide borrowers who make scheduled payment on time over the life of the loan a 6 month payment cancellation at the end of the schedule.

Form alliance with large banks and Credit Bureaus to provide the borrowers who pay their student loan on time and on schedule real incentives

- Ensure superior credit history in Credit Bureau reports.
- Gain preferred ‘tier1’ customer status with major banks.

Benefits:

Prevent delinquent borrowers from defaulting.

Improve borrower satisfaction (and rewards) for prompt payment.

Costs:

Cost of increasing participation in borrower incentive programs.

Establish partnerships with Lenders to reward prompt payment.

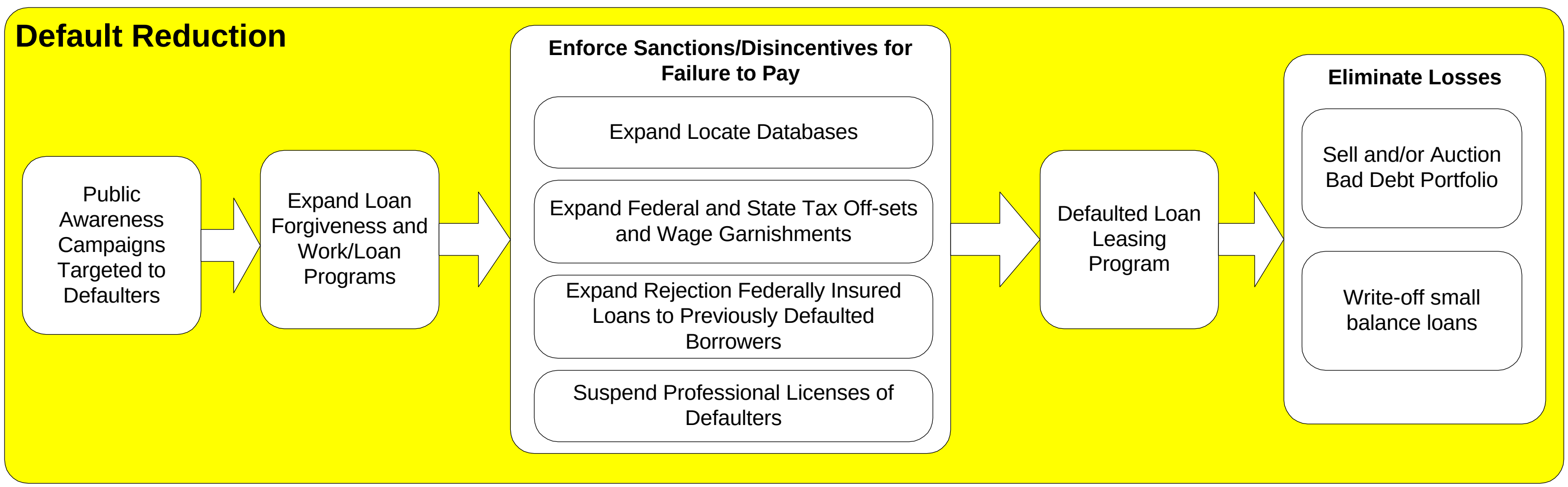
Recommendations - continued

Expanded Default Reduction Programs could help to lower the overall default rate by 2%, which could result in a net return of $ 1.4 Billion to ED

Objectives:

Implement an Enhanced Default Prevention Program to reduce the number of borrowers that default and reduce the average loan balance of those borrowers that ultimately default.

Increase percent distribution of available student aid funds by increasing awareness and access to Scholarship, Grant and Loan information, and make loan the last priority for student aid.



Desired Outcomes:

- Improve collections to reduce the default rate by 2% through incentives and sanctions.
- Reduce total default portfolio and improve accuracy of reporting by eliminating small balance and bad debt portfolios.

Recommendations - continued

Recommendation

Public Awareness Campaigns Targeted to Defaulters

Public awareness campaigns targeted to Defaulters

Implement targeted collection strategies for defaulters based on profiles.

- Utilize intelligent debt trend analysis tools to extract the targeted defaulters, who are able to pay.
- Develop a short video and send it directly to the targeted defaulters. The video should:
  1. Explain the serious consequences for defaulting on a federal student loan.
  2. Illustrate the financial benefits of voluntary loan rehabilitation and repayment arrangement.
  3. Provide other debt counseling material.

  The video should be sent out along with the DCS letters during the first 90 day period, when defaulted accounts are transferred from Guaranty agencies, and before being assigned to PCAs.

Benefits:

Potentially reduces default rates and collection costs.

Better understand defaulted borrower behavior and effective collection methods.

Better educate delinquent and defaulted borrowers regarding the effects of default.

Costs:

Cost of video production.

Cost of software purchase or lease.

Recommendations - continued

Student Financial Assistance

Recommendation

Expand Loan Forgiveness and Work/Loan Programs

Expand Loan Forgiveness and work/loan program

Expand the program to include all federal education loan borrowers with defaulted loans in exchange for social and community services.

- Participation in the federal Gear Up and other youth educational programs.
- Participation in state education programs for children.
- Participation in community services (helping the elderly people programs, clean-up programs and other social services).
- Participation in public service careers and social work.
- For each defaulter, 50% of its default amount can be reduced by working in pre-defined social and community work.
- Analyze the targeted audiences for a work loan payoff.
- Analyze the targeted audiences for a retroactive grant plan.
- The forgiveness program can be utilized as an incentive to borrowers to keep up with their regular repayment schedule through out the life of the loan.

· **Analyze the targeted audiences for a selected loan amnesty.**

Benefits:

Reduces default rates and collection costs.

Better understand defaulted borrower behavior and effective collection methods.

Qualified resources for community service.

Costs:

Opportunity cost for services rather than monetary loan repayment.

Coordination with state and local agencies to match resources to services.

Recommendations - continued

Enforce Sanctions/Disincentives for Failure to Pay

- Expand Locate Databases
- Expand Federal and State Tax Off-sets and Wage Garnishments
- Expand Rejection Federally Insured Loans to Previously Defaulted Borrowers
- Suspend Professional Licenses of Defaulters

Recommendations

Enforce Sanctions/Disincentives for failure to pay.

Expand use of existing federal and states databases to locate defaulted borrowers:

- State FAMIS Systems
- State Motor vehicle registration systems
- Federal and state employees from Federally Insured Mortgages (HUD)
- National New Hire Database (currently in testing phase)
- State tax refund intercepts (currently implemented in several states)

Expand Federal and State Tax Offset and Wage Garnishments

- Require states to garnish state tax refund to those debtors (implemented in several states)
- Require states to implement state and federal tax offset if needed.

Strengthen enforcement of current regulations, preventing a previously defaulted borrower from obtaining additional federally insured loans

Increase efforts to collect refunds from proprietary schools

Suspend Professional Licenses of Defaulters, e.g., physicians, attorneys, nurses, cosmetologists, etc.

Benefits:

Reduce the risk of additional defaulted loans by $300 million (assuming an average loan size of $5,000, a 50% risk of a 2nd default, and 125,000 defaulted borrowers)

Improve collections by almost $14 million if the default rate associated with proprietary schools were reduced to the current 8.8% average (a reduction of 6.7%)

Costs:

Cost of verifying borrower status at the time of FAFSA application.

Cost of additional interfaces.

Recommendations - continued

Student Financial Assistance

Defaulted Loan Leasing Program

Recommendation

Lease a portion of the portfolio to a private sector debt management company:

- **Select a set of random portfolios of defaulted loans from the DCS portfolio to test the effectiveness of various collection pilot programs, such as:**
  - A public/private partnership where ED retains 100% ownership in loans and thereby protects the special collection tools (e.g., TOP, AWG) that are available to ED.
  - Performance-based objectives for the Private Collection Agencies (PCA) so they can manage the portfolio with least amount of oversight.
- **Select a similar control group portfolio and continue current practices to provide a baseline for comparison of various pilots.**

Benefits:

Reduces default rates and collection costs.

Test the hypothesis that a private sector management team can increase collections and reduce operating costs more effectively than the public sector.

Reduced costs of system operations.

Costs:

Cost of default loan portfolio analysis.

The implementation of this recommendation will require a substantial amount of up front work by the DCS.

Recommendations - continued

Eliminate Losses

Sell and/or Auction Bad Debt Portfolio

Write-off small balance loans

Recommendation

Eliminate bad debt losses by:

- **Selling and/or auctioning bad debt portfolios to private third parties in the delinquent-debt market**
    - Conduct an asset valuation of the total debt portfolio must be made before determining what and how much to sell.
    - Engage portfolio management expertise focusing on analyzing default portfolio and recommending financial exit and collection strategies.
    - Minimize or eliminate debt losses is by selling and /or auctioning bad debt portfolio to reputable third parties in the delinquent–debt market.
- **Writing-off small balance loans**
    - Write off the old and small bad debt, the small amount must be determined, and the write off should be an on-going procedure, every six months or so.

<u>Benefits:</u>

Reduces default rates and collection costs.

Double or triple internal rate of return on old defaulted loans - equating to a net increase of $250,000 for every $10 million sold or auctioned at $.04 on the dollar, as compared with PCA collection rates.

Reduced costs of system operations.

<u>Costs:</u>

Cost of default loan portfolio analysis.

Bad-debt portfolio management resource cost.

Recommendations - continued

Although, fraud prevention and detection is not systematically tracked by SFA, based on recent OIG Reports, detected fraud exceeds $ 500 million per year. SFA could save as much as $5 to 10 million per year (1 to 2 percent) in prevention and recovery with more effective fraud control measures at the G.A., Lender, School, and Borrower levels.

<u>Objectives:</u> Implement a Student Lending Fraud Prevention and Detection Program coordinated with the Office of the Inspector General (OIG), Federal Trade Commission (FTC) and Department of Justice to reduce loss associated with fraud at the Financial Partner, School, and borrower levels.

Fraud Prevention and Detection

Expand Standardized Internal Control Procedures that focus on Fraud Prevention and Detection → Systematically Track and Analyze Fraud and Resutling Settlements with Borrowers and Organizations → Revoke Program Participation eligibility of Repeat Offenders

<u>Desired Outcomes:</u>

- Increase the identification of existing fraud and increase recovery of losses associated with fraudulent activity.
- Reduce repeated fraud activity and potential fraud through improved internal controls and tracking of fraud cases.
- Eliminate repeated offenders of fraud from program participation.

Recommendations - continued

Student Financial Assistance

Recommendation

Expand Standardized Internal Control Procedures that focus on Fraud Prevention and Detection

Expand standardized internal control procedures that focus on Fraud prevention

- Establish stricter eligibility re-certification requirement for schools with high default rates.
- Continue to establish and maintain internal control and to identify and address management challenges and areas susceptible to fraud, waste and abuse.
- Require guaranty agencies to track and investigate discharge claims when agencies suspect or obtain conflicting information about a claim, either before or after a discharge is granted.
- Re-instate improperly discharged loans if information shows that the borrower was, in fact, not eligible for the discharge.
- Clearly define the term ‘disability’ and communicate the definition to guaranty agencies and lenders.
- New schools with high default profile group should meet stricter federal guidelines before being eligible to title IV program participation.
- Measure vocational trade schools performance on an annual basis on the following critical outcomes, including student default rate; student completion of school rate; and job placement rate.
- More frequent on-site visit to those schools with high default rates.

Benefits:

Reduces overpayments.

Reduces default rates and collection costs.

Eliminates fraudulent Financial Partners from program participation.

Costs:

Coordinate with OIG, FTC, and DOJ to detect fraud and participate in fraud settlements.

Systematically track suspected fraud and results of fraud investigations for Financial Partners and individual borrowers.

Recommendations - continued

Systematically Track and Analyze Fraud and Resutling Settlements with Borrowers and Organizations

Recommendation

Systematically track and analyze fraud and resulting settlements with borrowers and organizations

- Implement tracking and reporting of fraud at the Financial Partner, School, and Borrower levels.
- Establish an active and confidential hotline for the public who wish to identify fraudulent and student loan cases.
- Run automatic data match with the Social Security Administration's Death Index to identify persons who received loan discharges based upon death, but who do not appear in the Social Security Death Index.
- Revise the disability form to include, at a minimum, the doctor's professional license number and office telephone number.
- Require an original or certified copy of the death certificate.
- Establish a specialty fraud unit for SFA, in coordination with OIG.

Benefits:

Reduces overpayments.

Reduces default rates and collection costs.

Eliminates fraudulent Financial Partners from program participation.

Costs:

Coordinate with OIG, FTC, and DOJ to detect fraud and participate in fraud settlements.

Systematically track suspected fraud and results of fraud investigations for Financial Partners and individual borrowers.

Recommendations - continued

Recommendation

Revoke Program Participation eligibility of Repeat Offenders

Revoke program participation eligibility of repeat offenders.

- Revoke Financial Partners participation and School participation eligibility for repeat offenders of fraud or gross mismanagement related to the FFELP, DL, and Perkins Loan programs, and Pell Grant Program.
- Prevent students who are repeat offenders of fraud from receiving any student loan, grants or scholarships.
- Enforce legal actions to suspend or revoke professional licenses of individuals who commit fraud against SFA, e.g., physicians who falsify death certification and disability certifications.

Benefits:

Reduces the risk of fraud.

Eliminates fraudulent Financial Partners from program participation.

Costs:

Coordinate with OIG, FTC, and DOJ to detect fraud and participate in fraud settlements.

Systematically track Financial Partners and School, and their key personnel to prevent fraud.

Recommendations – continued

Student Financial Assistance

Enabling Technologies

Recommendations

Replace DCMS with current technology/services to enhance DCS' capability to accurately and consistently monitor debtor and collection trends, to better interface with external data sources and to supply up-to-date statistics to the student financial aid administrators, public policy makers, and lawmakers.

- Require accurate and timely information from guaranty agencies, lenders and schools.
- Continue the development of the integrated, customized web interfaces.
- Consider the option to outsource both the debt collection system development, maintenance and user training to an experienced vendor,e.g., CACI.
- Conduct software selection process including functional requirement and gap analysis:
  - USA Group's Borrower Pursuit System (BPS).
  - London Bridge's collection system.
  - HNC – built-in intelligence and predictive capability in collection activities.
  - STRATA Portfolio management software.

Benefits:

Reduced costs of system operations by as much as $4-5 million per year.

Allows for tracking of Financial Partners, Schools, and defaulted borrower profiles to determine trends and analyze effective prevention efforts.

Costs:

Initial costs of development and implementation of new systems and software could range from $5 to $20 million, depending on technology and required functionality.

Implementation Strategy

Student Financial Assistance

Next Steps

- **Default Prevention**
  - Expand Public Awareness campaigns for student financial assistance options.
  - Develop requirements for a Public/Private Student Financial Assistance Central Repository.
  - Determine feasibility of a Universal Financial Aid Application (for grants, scholarships and loans).
  - Regulatory changes to ensure Student Loans are lowest priority student financial assistance (rather than highest).

- **Default Reduction**
  - Analyze the targeted audiences for a comprehensive loan amnesty/work-loan payoff and/or retroactive grant plan.
  - Analyze bad debt portfolio for sale or auction.
  - Write-off small and old defaulted loans (e.g. loans under $100.00)

- **Fraud Prevention and Detection**
  - Implement tracking and reporting of fraud at the Financial Partner, School and Borrower levels.

Appendix

The following appendices summarize the results of our research and analysis, including best practices, related projects, cost benefit calculations and references:

- Appendix A: Financial Services Industry Best Practices
- Appendix B: Student Loan Industry Best Practices
- Appendix C: Summary of Secondary Market for Bad Debt
- Appendix D: Enabling Technologies
- Appendix E: Cost Benefit Analysis Calculation Details
- Appendix F: Reference List